FAMILY LIMITED PARTNERSHIPS

A tool to transfer wealth to the next generation at lower tax cost.

provided by Glazer Financial Network

Family limited partnerships, or FLPs, let you make gifts of partnership interests to family members while you maintain control over the underlying assets.

In estate planning, FLPs can be very useful. Successful families create them with three objectives in mind: lowering income and estate taxes, enabling family business continuity via orderly transfer of ownership interests, and establishing a degree of liability protection for limited partners.[1]

About a decade ago, the IRS decided to scrutinize and challenge a few FLPs. But in the last few years, tax courts have issued some notable and favorable rulings on behalf of such partnerships. As income and estate taxes could rise after 2012 if the Bush-era tax cuts expire, families with business might want to look into FLPs.[2]

The FLP structure. A FLP usually starts out with married business owners placing assets into a partnership. Initially, the parents are both the general partners and limited partners. In time, they gift limited partnership interests to sons or daughters.

What does this mean? Basically, it means that the couple has relinquished ownership of 1-99% of the assets in the partnership, but still controls 100% of these assets. The limited partners (the kids) have no voice when it comes to running the business. The parents always control 100% of the FLP assets because they are the general partners. (The children would only become general partners upon the death of both parents.)[3]

What the FLP accomplishes. Let's present a hypothetical example, in which parents (general partners) gift a limited partnership interest and give up ownership of 75% of assets within the partnership. This 75% of assets is now outside of their taxable estates. All future appreciation of these assets will also occur outside of their taxable estates. Yes, they have made a gift to their kids, so here comes a gift tax – but the general partners can use the unified gift and estate tax credit to pay it off.[3]

If the parents transfer 75% of their ownership interest to the limited partners, 75% of the income generated by the FLP will be taxed to the limited partners.[3] If you are in a higher tax bracket than your children, you can see the value of this.

Besides potentially sizable tax savings, the FLP also offers asset protection through the limited partnership entity. Where 100% of this couple's assets were once vulnerable to "creditors and predators", now only the 25% they directly own will be exposed. The 75% of partnership assets they transferred to the limited partnership interests are now out of the bullseye.[3]

A FLP should have one purpose. It is a tool to help families plan to sustain family businesses over two generations. Any deviation from that purpose might someday draw the attention of the IRS. For example, it is a bad idea to transfer real estate into a FLP or to use the FLP like a piggy bank to pay for personal expenses. It should not appear that the FLP has just been set up to save taxes – if you can show demonstrable non-tax reasons for creating it, so much the better.[2]

FLPs are not limited to family members. In fact, FLPs may include an attorney, a bank, or another independent third party as a general partner that may later be replaced or removed from the partnership. This third party can decide on valuations, discounts and distributions.[4]

If you have thought about a FLP, move carefully. Before you go about creating a FLP, confer with the tax and legal professionals you retain, or find trusted tax and legal professionals through referral. With their input, you can determine whether the FLP is an appropriate asset transfer and estate planning tool for your family.

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Citations.

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